TESTIMONY

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Before the

Financial Institutions and Consumer Credit Subcommittee
Financial Services Committee
U. S. House of Representatives

June 19, 2003

It is a pleasure to appear today before you to discuss Mellon Financial Corporation's views on the pending changes to the capital, supervision and disclosure rules. Although complex—sometimes extraordinarily so – these new rules will have a profound impact on the competitiveness of U.S. financial services firms and on the products they provide to American consumers, companies and investors. Basel's rules also will have a profound impact on the global economy. Although the rules are not now scheduled to go into effect before 2007, they will in fact have a major impact on financial markets far more quickly. Thus, your review – and that of other panels in the Congress – is timely and commendable.

The Basel rules are of keen concern to Mellon because we focus on specialized lines of business around the world. We are a financial services company with 22,500 employees in 21 countries. Headquartered in Pittsburgh, Mellon is one of the world's leading providers of financial services for institutions, corporations and individuals, providing institutional asset management, mutual funds, private wealth management, asset servicing, human resources and treasury services. Basel will have a major impact on all of these lines of business, where U.S. banks now have created a global comparative advantage through aggressive investment in leading-edge technology and the sophisticated risk management and related systems developed to support these activities. Mellon has approximately $2.9 trillion in assets under management, administration or custody, including $566 billion under management.

At the outset, I would like to express Mellon's gratitude to all of the regulators – U.S. and elsewhere – who have spent literally thousands of hours crafting these revisions. Of particular note is the new emphasis on a more balanced approach to bank regulation – what Basel is calling the "three pillar" approach. I strongly agree that capital rules aren't the sole touchstone of bank safety and soundness. Indeed, undue reliance on capital adequacy can divert attention from latent, serious problems in internal controls, strategic decision-making and other key risk areas. Thus, Basel's decision to look not only at capital, but also at supervision and disclosure will result in a far stronger global financial system going forward.

All of the hard work is also justified by the worthy goal with which Basel started: an end to regulatory capital arbitrage. All sophisticated banks and their holding companies – Mellon included – have gotten better in the past decade at spotting inconsistencies between the regulatory capital standards that bind us and the economic ones that are demanded by the broader markets. Better alignment of regulatory and economic capital will reduce this dichotomy and ensure that regulatory capital incentives promote the laudable supervisory goal of increased bank safety and soundness.

Unfortunately, since Basel started, its goals appear to have changed. As recently stated in a document released by U.S. regulators, the Basel goals now are improving internal controls and capital allocation, promoting market discipline and adding a new capital charge for operational risk. Mellon strongly supports the first two goals, but the third – a new one – in fact undermines the first two by creating perverse incentives to undue risk taking. The operational risk-based capital (ORBC) requirement could also put U.S. banks at a serious competitive disadvantage versus non-banks here and non-U.S. financial services firms around the world**.** The U.S. decision not to impose the most flawed ORBC proposals, namely the basic and standardized capital approaches, does not negate the fact that these will be mandated elsewhere, with potential serious safety-and-soundness results. Setting ORBC on a simple percentage of gross income creates perverse incentives to risk-taking, as I shall discuss in more detail below, and the U.S. should fight hard against this in Basel II to ensure that all of the world's large banks are under a proper regulatory capital regime, not just those here at home. Systemic risk must be an over-riding consideration as Basel II is finalized, and the ORBC proposal thus poses especially serious challenges.

As requested by the Subcommittee, I shall focus my comments today on issues of particular importance in the U.S., with a focus on recommendations for the pending advance notice of proposed rulemaking (ANPR) to be released by the bank regulators. I would like to recommend:

- complete elimination of the "Pillar 1" ORBC charge. The goal of promoting internal controls and capital allocation can far better be achieved through addressing ORBC in "Pillar 2" – i.e., improved bank supervision;
- the U.S. should not force all large banks into the most advanced versions of Basel II, as these are also the most complex and not necessarily appropriate for all large banks. Specialized banks like Mellon (which holds less than $5

billion in loans in its lead bank) do not require the advanced internal ratings-based approach for our credit risk book of business. The standardized approach for credit risk that will be used in the European Union appropriately controls regulatory arbitrage for specialized banks;

- there is no need to continue the arbitrary 8% or 10% capital ratios, or the overall leverage capital standards. To achieve the end of the arbitrage that Basel and the U.S. regulators rightly seek, low-risk banks should hold regulatory capital appropriate to their position – which could be well below the current regulatory levels set in 1988. High-risk banks should similarly hold the right amount of capital, likely far more than now imposed. A simple, overall capital ratio undermines the goal for which Basel and the U.S. have worked so hard for so long; and
- operational risk-based capital should not be used in either Pillar 1 or Pillar 2 to "top off" credit risk capital. Each bank should hold regulatory capital appropriate to its risk profile, with market forces and the bank's preferences determining when more than the risk-determined amounts of capital are held.

Operational Risk-Based Capital: Take it Out of Mandatory Regulatory Capital Requirements

Like many specialized U.S. banks, Mellon is extremely concerned that imposition of the ORBC charge will have an unintended and undesirable impact – and not just on us. We see very unfortunate policy consequences, as well as adverse competitive ones, from this proposal. As a result, Mellon is a member of the Financial Guardian Group, an organization for those U.S. banks most concerned with this section of Basel II.

Let me first detail the policy concerns we have with the ORBC charge. Fundamentally, Basel – and the U.S. regulators, if they follow it or if it can't be changed – would impose a regulatory capital charge against a risk that can't be measured or even defined in a fashion on which all agree. Indeed, the Risk Management Group of the Basel Committee's most recent review of operational risk said that its own data should be used with "caution" because they "do not permit identification of business lines and/or event types that are the largest source of operational risk." Basel in this survey found that banks in the still small sample from which data can be obtained (only 89 banks in 19 countries responded to the survey) view appropriate amounts of operational risk in ranges from .09% to 41% — a huge range from which no meaningful conclusions can be drawn. How can Basel or the U.S. press on with a capital charge on which there is so much variation?

How is operational risk defined? Basel of course has tried to do so, but there's still no agreement on whether catastrophic risk – September 11, for example, is in or out. The most recent version of Basel II indicates that banks under the most sophisticated version of the ORBC charge must account for this catastrophic risk, even though no one knows how to measure it, let alone decide just how much capital would be enough – or if any amount of capital would be sufficient.

There's also still no agreement on how to differentiate operational risk from credit risk and how to reflect well-understood risk mitigation steps like reserves and insurance. Fraud, for example, is counted by Basel as an operational risk, but most lenders – especially retail ones – consider this a routine credit risk. Credit-card lenders, for example, have well-tested models that accurately predict how much fraud to expect in their various books of business, and these are reflected in pricing, earnings, and reserves. A capital charge atop these simply serves no purpose – other than perhaps to increase the cost of credit to American consumers. As I shall discuss a bit later, the new capital charge for "legal risk" puts U.S. banks at an undue competitive disadvantage because of the unique nature of our laws. However, it is also one where reserves are required when material legal problems arise. Basel II includes no credit for these reserves, even under the advanced measurement approach. This double-charge is unnecessary and inappropriate, and it also shows how much work remains to be done to understand when operational risk truly poses a safety-and-soundness problem.

Fundamentally, regulatory capital is the wrong way to address operational risk, especially catastrophic events. Had this requirement been in effect on September 11, what good would it have done? Just how much capital could the banks at Ground Zero have held to fend off the planes or ensure quick resumption of operations? Capital is intended in part as a discipline on management and directors to ensure that shareholder money is at first risk before deposit insurance funds or the resources of a central bank lender of last resort are called upon. This makes lots of sense in areas where banks run risk for profit, but no institution puts itself at catastrophic operational risk to bypass the regulators. What works to prevent and mitigate operational risk – even catastrophic ones – are back-up facilities, extensive policies and procedures, training, contingency planning and insurance – all of which proved their worth on the tragic day of September 11 and the days thereafter.

In fact, a regulatory ORBC charge creates a perverse incentive to avoid these proven forms of operational risk management and mitigation. The U.S. appears to have recognized this by its decision not to impose the “basic indicator” and “standardized” versions of ORBC in Basel II. These are based solely on a percentage of gross income – a crude number which has no known relationship to the actual amount of operational risk a bank may run. Indeed, gross income is often inverse to risk, as less profitable banks may very well run higher amounts of operational risk. Moreover, such an approach penalizes those institutions that have better controls and systems, as such attributes will be recognized in the marketplace of sophisticated buyers and those institutions will likely have higher gross income but thereby incur a larger ORBC charge. Even though the U.S. doesn’t plan to impose the gross income-based charge, it should fight hard against it in Basel because imposition of this approach creates risk for the global financial system and, thus, U.S. banks and the economy that depends on them.

Further, the “advanced measurement approach” (AMA) the U.S. plans to impose does not correct the fundamental flaws in the regulatory ORBC proposal. As noted, there’s no agreed-upon definition of operational risk, nor any good measurement of it. Putting ORBC in Pillar 1, even with deference to internal models, doesn’t solve these basic policy problems and creates serious competitive problems for specialized U.S. banks as a result.

Unique U. S. Considerations

Under U.S. law (for example, the FDIC Improvement Act and Gramm-Leach-Bliley Act) capital counts. This is right and proper, but it is sadly not the case in many other jurisdictions where large financial services firms compete vigorously against Mellon and other U.S. institutions. Pillar 2 in the Basel rules is intended to address problems where banks do not meet the capital standards, but the Basel II proposal says sanctions can include "moral" guidance and directives to improve risk management – that is, closed-door discussions that can allow banks to operate below Basel standards for years. In sharp contrast, U.S. banks are subject to major sanctions if they fail the "adequate" capital tests (such as Prompt Corrective Action sanctions), and financial holding companies must hold only "well-capitalized" banks. Thus, once ORBC is in the regulatory capital standards – regardless of its manifest flaws – U.S. banks will absolutely and unconditionally have to comply with its requirements, and European or Japanese banks could be held to far less stringent account.

A Pillar 2 supervisory standard would give U.S. regulators all the power they need to impose the appropriate amounts of operational risk-based capital – indeed U.S. regulators are already holding banks here to that standard under Federal Reserve Supervisory Letter SR 99-18. Thus, U.S. regulators should be putting their effort into ensuring that other national supervisors adopt the tough approach to appropriate regulatory capital for credit and market risk, not super-imposing a flawed charge here to keep the Basel II negotiations moving forward. It should be noted that Interest Rate Risk, which led to the enactment of FDICIA and the massive thrift failures of the late 1980's, is not subject to a Pillar One capital charge, although that risk is quite measurable and has actually led to bank failures and instead is treated under Pillar Two.

Further, the ORBC capital charges under Basel II – including the advanced one planned here – includes a regulatory capital charge for "legal" risk. This is defined to include the risk resulting from tort liability, securities suitability standards, and the laws against loan and employment discrimination – among many others. These standards, of course, do not apply in many other nations. We fail to understand why U.S. regulators would agree to a capital charge for U. S. banking institutions arising from laws and regulations unique to the US that are designed to achieve our own social objectives – especially given the unique U.S. requirement for reserves against material legal risk. In addition, these are laws which have no known bearing on any bank's failure. In cases where a bank may be subject to legal risk, securities law requires full disclosure of material concern – with the ORBC proposal thus having no impact on market discipline.

As U.S. regulators consider Basel II's impact, another unique factor should be given careful scrutiny. Not only does regulatory capital matter the most in the U. S. for banks, but banks (and their parent financial holding companies) are also the only financial services firms that come under bank regulatory capital standards. Thus, to the degree that bank regulatory capital differs from the economic capital demanded by the marketplace, U.S. banks will be placed in a different competitive position from major financial services firms that operate outside the banking rules. When bank capital standards are too low – as is the case in some key credit risk areas – this pushes low-risk assets out of the bank with perverse safety-and-soundness impact. When regulatory capital is too high – as will be the case with ORBC – non-banks have a major competitive advantage.

U.S. regulators could address this competitive problem by adopting a truly "functional regulatory" approach to the Basel standards. Currently, Basel II requires imposition of all of the new capital requirements at the holding company level. This may make sense in the EU or Japan, where the laws permit up-streaming banking standards to the parent level, but it raises profound competitive problems here where the law does not allow this. To date, the Federal Reserve – the holding company regulator – has generally mandated consolidation of capital to include bank-like standards on non-banking operations. The sole exception to this is investment companies, which Congress mandated in GLBA be outside of bank-like capital imposed through the holding company. Imposing bank-like capital in the U.S. only on banks would help resolve the many competitive problems in this market where bank holding companies compete against major non-bank financial services firms.

This competitive issue is of particular concern to specialized banks. In areas like asset management and payments processing, many major competitors operate outside the banking rules. U.S. law allows these companies to have insured depositories for specialized purposes – credit cards, for example – but to offer asset management or similar services in holding company entities that don't come under the bank regulators' oversight and supervision. In fact, 180 of the largest 200 asset managers in the U.S. are non-banks. Similarly, the four largest payments processors are non-banks. This makes such firms major competitors with a competitive leg up. Should the U.S. rules include the Basel ORBC charge, specialized banks will be placed at such a competitive disadvantage that they will have to consider revising their charters into the non-banks their competitors successfully manage free of ORBC capital charges. This does nothing to promote the safety-and-soundness objectives that bank regulators rightly seek. In fact, it would increase systemic risk by potentially pushing business outside the strong and effective U.S. bank regulatory system.

Regardless of all of the acknowledged flaws in the ORBC proposal noted above, EU regulators at least have the luxury of knowing that they will bring all large financial services firms into the new scheme. This won't do anything to solve the systemic risks caused by perverse incentives, but it at least won't push key financial activities outside the banking charter.

No One-Size-Fits-All Approach

U.S. regulators are considering a unique approach to Basel implementation not only by imposing the new rules only on the largest internationally active banks, but also by imposing only the most sophisticated versions of the capital rules, namely, the Advanced Internal Ratings-Based approach on the credit side and AMA on the operational risk side.

As noted, this does nothing to fix the admitted flaws in the simpler approaches to ORBC. Further, it could force U.S. banks with small books of credit risk to assume substantial and unnecessary cost.

Mellon concurs that the standardized version of the credit risk-based capital (CRBC) rules includes many simplifications that lead regulatory capital to diverge from economic capital. However, we believe these differences do not pose serious risk in banks with small, relatively simple and generally low-risk credit risk books. Mellon is one such bank, as our major focus is on the specialized lines of individual and institutional services I have noted above.

A recent survey of the cost of Basel implementation at large banks puts the cost of developing the data and running the Basel models at between $50 million and $200 million per bank. We see no need to run this large cost when simpler CRBC models are at hand that address the largest problems in Basel I. Again, many of our competitors are non-banks, so this cost will put us at an undue competitive disadvantage in relation to the improved safety-and-soundness for which we, like our regulators, aspire. Given the other charter options available to U.S. banks, undue Basel costs with adverse competitive implications will exacerbate the move towards non-bank charters. The adverse competitive situation is aggravated where a nonbank affiliate of a bank or financial holding company is subject to Basel II while its nonbank competitors are free of those capital requirements.

Risk-Based Capital Should Vary with Risk

Another potential unique aspect of the U.S. Basel rules is a requirement that each bank's capital not fall below current requirements. Since Basel II's goal is to end the arbitrary capital standards mandated by Basel I, super-imposing a total amount of capital unrelated to risk atop the results of the complex Basel II models quite simply makes no sense.

We believe each bank's capital should rise or fall with its risk. Banks that invest in nothing but very high-quality assets and supplement these with state-of-the-art risk management techniques should not have to "top off" their regulatory capital to the same levels set for far riskier banks. Indeed, if required to do so, low-risk banks which will have to otherwise set aside capital to meet Basel II will very likely need to run higher risks in order to push for returns on capital high enough to meet market expectations. Basel II is intended to end risk arbitrage to promote safety-and-soundness, but an arbitrary requirement to meet an overall 8% capital standard on top of the results of accepted internal models will have a perverse result.

ORBC Shouldn't Be Used to Fill CRBC Holes

As the Basel II models have been run of late, banks with low-risk books of business are in fact finding that their CRBC might fall below current levels. This is a reward for appropriate risk management, and should be permitted in the final rule. Fearful of any such drops, however, regulators are using the ORBC requirement as one of their solutions to this non-existent problem. As the recent quantitative impact survey of Basel II makes clear, total capital under the advanced Basel II models could drop for all large banks in the G-10 countries (which includes the U.S.) by 11% — with the ORBC requirement bringing levels back to current requirements. Banks with big books of mortgages or consumer loans could see their CRBC drop still further, with ORBC again being used to plug any such holes.

Interestingly, some recent U.S. data suggest that the Basel results may under-estimate total CRBC, based in part on optimistic assumptions built into the models of reporting banks. U.S. regulators have seriously questioned some of these results, although they are in the Basel survey, and the actual U.S. CRBC standards could be far more stringent. If so, then ORBC will be an added charge on top of a sharp increase in overall credit risk-based capital, possibly resulting in a major curtailment of banking operations with undue economic consequences at home and abroad.

The Basel quantitative impact survey also indicates that the banks with the largest increase tend to be the most specialized institutions, even though they carry little credit risk. This is the result of the new ORBC charge, but Basel data also show that these same specialized banks have the lowest incidence of actual operational losses. Capital simply shouldn’t go up so much for them in order to keep credit risk capital at its current level.

Further, credit and operational risk don't necessarily bear any relation to each other. Banks with lots of credit risk because of their subprime or similar loan portfolios can have terrific operational risk management and mitigation processes in place; conversely, banks with low credit risk can be ill-prepared for sudden operational disruptions.

As a result, regulators should assess safety-and-soundness on these two very different dimensions in a fashion appropriate to each. CRBC should be set in accordance with actual credit risk, and operational risk of concern to supervisors should be addressed through vigorous safeguards and, if necessary, sanctions. U.S. regulators have full authority to impose these – indeed, they do so now – and Basel II should focus on ensuring that all other nations bring their standards up to these levels and then enforce them.

In conclusion, we believe the issue of how operational risk is treated in Basel II has the potential to have major unfavorable competitive implications for the US banking institutions and affiliates that have made major investments in technology, systems and controls over the years. These prudent investments have resulted in favorable comparative advantages for those organizations and the US that could be quickly lost.